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Direct Taxation in the European Union Countries
- Part II -

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Abstract

The importance of the topic lies in the role played by taxation and fiscal reforms in this field for the economic development of the states around the globe especially as this paper focuses on the Member States of the European Union, which record different levels of taxation and where there are still quite a few different approaches to taxation, despite sustained efforts towards convergence.

The involvement of our country in this process of European integration is based on removing the inconsistencies and failures of previous reforms, as well as reconciling the objectives of efficiency, effectiveness and equity that are the foundation of an optimal tax system.

Key terms: OECD, EU, tax system, Fiscal Code, convergence, fiscal policies, double tax treaties

JEL Classification: K34, H87

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➲ Fiscal policies regarding direct taxes

The tax is, together with public spending, a variable of budgetary policy. Policies that focus on the global demand are used as a means of short-term stabilization. Knowing this, a decrease of taxes could cause a multiplier effect that stimulates the activity of economic agents leading to an increase in the disposable income. An increase of taxes will have an inverse effect.

Arthur Laffer is famous for the idea that he demonstrated with the help of a curve that is now named after him, according to which from a certain threshold any increase in fiscal pressure causes a decrease in the mandatory amount collected by the public power. According to this curve, the amount of governmental revenues collected by the state is directly proportional with the tax rates, but only up to a maximum threshold, which corresponds to the highest point of the curve, after which it starts as a decreasing function of this rate, even going to cancellation if the rate reaches the theoretical level of 100%. According to Laffer, very large collections of mandatory duties destroyed the way taxes were settled. This causes a phenomena of resistance and reduction of productive effort (disintegration of labor, savings and investments) that will reach such a magnitude that it determines the decrease of their total amount.

Laffer, like the other economists, estimates that when the maximum threshold of the income is exceeded and there would be a decrease in fiscal pressure, it would lead to an increase in the yield of compulsory withdrawals, revitalizing the economy providing labor, savings and investments (Cioponea, 2007).

A study conducted by Christina Romer, the former chairman of President Barack Obama's Economic Advisory Council, and her husband, David Romer, suggested that the top of the curve appears at a much lower level of taxation, somewhere between 33 and 40%. The study analyses how the gross domestic product responds to the tax rate and indicates that when the taxes are lower, government revenues will increase.

The fiscal obligations were classified actually in accordance with the classification of the governmental state revenues, from a structural point of view corresponding with the order established in the state and local budgets. Taxes were divided by direct and indirect categories correlated with the current income. The main categories of direct taxes are corporate profit tax, microenterprise tax, salary tax, personal income tax (deriving from different activities), dividends tax and contributions.

Direct taxes can also be classified into real taxes and personal taxes.

The real taxes are placed on material objects, without taking into account the personal situation of the subject, being known as objective or product taxes (land tax, building tax, industrial activities tax, commercial activities tax). Personal taxes are based on income or wealth, depending on the personal situation of the taxable person, being called subjective taxes (inheritance taxes, wealth taxes, donation taxes, liberal professions taxes).

Any natural or legal person is obliged to pay its fiscal obligations to the state within the established deadlines. The payers are responsible for the strict observance of the provisions contained in the legislation regarding the taxable income. Direct taxes are characterized by the fact that they are nominally established in charge of natural or legal persons, depending on their income or wealth, based on the tax rates provided by law.

In the research paper conducted by Moșteanu and Mitroi (2015) entitled *European Tax Model*, the authors present a comparative analysis of the European Union Member State's taxation systems in achieving the public revenues. They presented the main tax model from Europe from a theoretical perspective as follows: Continental, Mediterranean, Anglo-Saxon, catching up and Nordic. Their findings suggested that the EU will not hesitate to take action in order to ensure the compliance with the taxation principles of proportionality and subsidiarity. As long as the EU taxation matters will be in place and the Member States will develop their fully optimized and fair tax system, the Union will not interfere with the right of each state to choose their own tax system freely. Many members of the EU refuse to give up their sovereignty, so the harmonization of direct taxes will not be possible as it was for the indirect taxes.

Some of the arguments in favor of the fiscal harmonization are presented below:

- Suppression of the discrimination and the risk of double taxation;
- Prevention of involuntary cases of non-taxation and tax evasion, especially at the level of intra-community operations;
- Preventing the loss of revenue associated with tax competition and weakening revenues, by migrating national tax bases between Member States, in the scope of fiscal optimization;
- Reduction of compliance costs due to the inclusion of non-residents under the provisions of several tax systems;
- Non-valorification, by some Member States in relation to others, of the advantages of a single market, but also from the point of view of the international distribution of tax revenues;
- Distortion of the establishment and of the allocation of budgetary resources, with negative consequences on the level of financing of public expenditures.

■ The taxation system in the Eastern EU countries (Romania, Bulgaria, Poland)

Romania, Bulgaria and Poland are some of the Eastern European countries that joined the space of the single market between 2004 (Poland) and 2007 (Romania and Bulgaria). All three countries are former communist countries that today have an important thing in common: they are Member States of the EU, they have not adopted the Euro currency, each having their own currency different from that of the emerging countries group (Romania – Romanian Leu, Bulgaria – Leva, Poland – Polish Zlot).

In accordance with Title I Article 3 to the Fiscal Code, the fiscal principles of Romania that are the basis of establishing duties and taxes are the following:

- Neutrality – taxes are not conflicted with the administration of the economy, but help the management of the taxpayers;
- Certainty – the size of taxes, deadline and methods of payment are established without interpretation;
- Equity – taxes are collected accordingly with the income obtained by each natural/legal person;
- Efficiency – the compliance with the Fiscal Code will not lead to unfavourable effects for individuals and legal entities;
- Predictability – changes to the tax legislation are inefficient and the tax payers are more readily willing to accept an old tax, so the stability could be ensured.

According to the taxable subject criterion, direct taxes are divided into two categories: the tax directly borne by the natural person and the tax directly borne by the legal person. Direct taxes borne by individuals are subject to taxation by individuals who have their domicile or residence in the state benefiting from their tax and non-resident persons earning income in that country.

In Romania there are a few people who are exempt from paying tax: foreign diplomats, royal families, sovereigns, persons earning income below the taxable minimum and some military personnel. Regarding the direct taxes paid by individuals, the taxpayer's situation is also taken into account (marital status, existence of a disability, number of dependents) in its calculation.

In Romania, in 2018 new measures were implemented regarding the fiscal framework related to direct taxes and social insurance contributions. While the Romanian corporate income tax (CIT) is 16%, an important change is the reduction of the income tax rate from 16 to 10% (Fiscal Register of social contributions). Regarding social insurance contributions, the tax burden related to the employer was transferred to the employee in order to ensure a better collection of revenues to social insurance budgets and to rebalance the state social insurance budget. The transfer of contributions to the employee was preceded by a 25% increase in salaries in the budget sector so that net income was not influenced by this transfer.

The Bulgarian tax system is composed of national and local taxes. The direct national taxes are the following: corporate income tax, withholding tax (WHT), one-off tax on certain expenses, alternative tax and personal income tax (PIT). The corporate tax rate applicable in Bulgaria is 10% and applies to profits obtained by companies registered in Bulgaria and by the permanent establishment of non-residents, in accordance with the Fiscal Code of Bulgaria.

The personal income tax is paid by individuals who earn income on the territory of Bulgaria and although income is at the core of this tax, the Law on personal income taxes on natural persons does not explicitly define income, and instead links income to its sources, distinguishing itself in the following five types: income from work, economic activity income, income from rents, income from the transfer of property rights, income from other sources. It is mentioned that donations and inheritances are the only sources of income exempt from tax. The tax rate is 10% for individuals and 15% for sole traders.

The Bulgarian withholding tax is paid on the amount paid as dividends and the liquidation of shares, of 5%, and on the repatriation of profits where a permanent establishment is not in place, of 10%.

The main characteristic of the Polish system is that taxation is not necessarily related to the existence of the legal personality of an entity. Thus, there are some entities, for example, branches, that owe profit tax. However, partnerships (for example, a general partnership) do not owe this tax. Resident companies that make profits anywhere in the world are subject to income tax, while non-residents are subject to this tax only for income earned on the territory of Poland. The profit tax rate is 19%. The determination of the taxable base is made by taking into account the taxable income and the deductible expenses.

The Polish tax system distinguishes nine types of direct taxes, as follows: CIT, PIT, tax on civil law transactions, real estate tax, tax on means of transport, inheritance and donations tax, agricultural tax, forestry tax, tax on dogs.

Poland, unlike other neighbour country, applies the progressive tax, but uses only three tax rates: people who earn an annual income of up to 722 Euros are not taxed, for incomes between 722 and 20,000 Euros a tax of 18% is paid and those who make more than 20,000 Euros/year pay a tax of 32%, in accordance with the Fiscal Code of Poland. In Poland, this tax is progressive and applies as follows:

Table 1. Polish PIT rates

Taxable base in PLN		Tax	
More than	Up to		
	85,528	18 per cent	Minus tax-reducing amount
85,528		PLN 15,395.04 + 32 per cent of the surplus over PLN 85,528	

Source: https://www.paih.gov.pl/polish_law/taxation/pit#

To determine the taxpayers who owe personal income tax, the same distinction is made between residents and non-residents. Residents owe tax for all income they make, while non-residents only for income made in Poland. Dividends are taxed at 19%, but the double tax treaties (DTT) may stipulate a lower rate (5, 10 or 15 per cent).

In Romania, Bulgaria and Poland, the catching up model of taxation prevails. Governmental revenues are mainly composed of indirect taxes, the GDP is composed of twice the indirect tax revenues than direct tax revenues and the tax rates are low in order to encourage business development. Tax incentives are granted in order to support start-up businesses and the reorientation of labour force towards the public sector.

■ The taxation system in the Western EU countries (Germany, Italy, France)

Some of the most developed economies and great industries are Germany, Italy and France, which are some the founding member of the European Union. At European level, the relationship between accounting and taxation is expressed by two opinions (Feleagă, 1996):

- In the United Kingdom there is a disconnection between the accounting and the fiscal result;
- In France, Germany and to a lower extent in Italy as well, there is an alignment between accounting rules with fiscal rules.

Germany stands out with a very high share of social security contributions, since the Continental model is found here, and employment and wages are the main contributors to the social transfers.

The personal income tax is a progressive tax ranging from 0 to 45%, and a classification criterion is the marital status as shown in the table below:

Table 2. German PIT rates

Taxable income range for single taxpayers (Euros)		Taxable income range for married taxpayers (Euros)		Tax rate (%)
Over	Not over	Over	Not over	
0	9,744	0	19,488	0
9,744	57,918	19,488	115,836	14-42*
57,918	274,612	115,836	549,224	42
274,612	And above	549,224	And above	45

* Geometrically progressive rates start at 14% and rise to 42%.

Source: https://taxsummaries.pwc.com/germany/individual/taxes-on-personal-income

In addition to the income tax, there is a solidarity surcharge of 5.5% collected in order to sustain the infrastructure and the economy in certain regions, but it has been announced that the government is planning to abolish this tax in 2021.

As of January 1, 2009, the option to evaluate the income from private investments and capital gains came into force, these being taxed at the source, at a rate of 25% (plus the additional solidarity tax).

Corporate income tax has increased from 15% to 15.825%, with a solidarity surcharge of 5.5%. Together with the municipal tax, which is 14-17%, the general tax rate is about 30-33%.

The German withholding tax ranges from 25% for dividends and interest to 15% for royalties, and it is influenced by the double taxation treaties.

In France, the corporate profit standard tax rate is set at 31% for fiscal years beginning on or after January 1, 2019, 28% for fiscal years beginning on and after January 1, 2020, and 26.5% for fiscal years beginning on and after January 1, 2021, in accordance with the Fiscal Code of France. Corporate tax affects mainly all taxable profits or incomes made in France by capital companies and other legal persons, but the legal persons may choose to be subject to CIT. Small and medium entities are taxed at a reduced rate of 15% for the first 38,120 Euros in profit.

A personal income tax is levied annually, being applied to the overall annual income, on a system of progressive quotas. The highest tax rate is 45% to which a surtax of 3% or 4% is applied depending firstly on marital status and on the amount of income. A notable feature of the system is the large number of thresholds and exemptions applied.

The withholding tax is not levied on resident corporations and individuals, only on non-residents. The amounts of WHT are stipulated in the double tax treaties and for countries for which France does not have an in force DTT, the rate ranges between 0 and 33.33% depending on the type of payment to non-residents.

In Italy, a 3% profit tax applied to internet companies with a turnover of over 750 million Euros globally and at least 5.5 million Euros came into force on January 1, 2020. The tax is similar to the so called "GAFA" tax applied to Google, Apple, Facebook and Amazon in France (Albu, 2020).

In Italy, the increase in the tax burden on direct taxes can be explained by the fact that the efficiency of collection has been improved by taking measures in this regard: intensifying tax inspections in conjunction with cross-audits between Member States and measures to combat tax evasion and signing agreements to ensure the exchange of information.

Italian entities are subject to a 24% CIT to which the quota of 3.9% regional production tax is added which varies depending on regions or on the core activity of the entity. The tax for non-operating (holding) companies is 34.5%. With regard to the personal income tax, individuals are subject to a national income tax, a regional income tax and a municipal income tax. The national income tax ranges between 23 and 41%, while the regional income tax ranges from 1.23 to 3.33% and the municipal income tax, from 0 to 0.8%, all depending on the amount of taxable income and regions.

Unlike France, Italy applies a WHT rate of 26% on interest for resident corporations and individuals, the DTT quotas for the states that have such a treaty in place, while for non-residents, the WHT ranges from 26 to 30% depending on the type of payment.

Within the Continental model that could be found in France and Germany, we can observe that the percentage of tax burden is the highest regarding the personal income, while in Italy, where the Mediterranean model is present and the main characteristic of this model is that the focus on revenues from indirect taxes, the PIT is still high compared with Portugal and Spain, which have the same model, reaching almost the same levels as the continental countries.

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➲ Double tax treaties

The double taxation treaties were designed in order to regulate the fiscal legislation between different countries, since the fiscal policy is not the same in two distinct countries, and in order to satisfy the need of the taxpayer to not be taxed twice on the same amount of income. At the basis of each double tax treaty lays the concept of residency or non-residency, which constitutes the criteria based on which each state decides whether to impose a certain tax or not.

International tax practices show that granting tax reductions or unilateral exemptions by countries where the income originates in order to avoid international double taxation is not a common phenomenon, because each of these states is interested in attracting as much tax revenue as possible. They consider that the states where the incomes are realized have priority in the application of taxes and the reduction of the fiscal burdens with the aim of avoiding double taxation must be granted by the state of residence of the taxpayer.

Although the regulations adopted by this category of states in the form of tax exemptions or reductions are in favour of the existence of unilateral measures to avoid double taxation, they can be considered as more intended to achieve economic policy objectives such as the stimulation of foreign capital or technology imports, rather than to avoid double taxation on an international scale.

The most often applied unilateral measure in order to avoid double taxation is granting a fiscal credit for any tax paid abroad in the country of residence. The practices of the states that allow the transfer of taxes paid abroad show that the maximum limit of the fiscal credit cannot exceed the level of fiscal obligations generated by the fiscal legislation of the respective state.

The tax credit method can also have the effect of eliminating double economic taxation at the international level. Many countries offer the indirect tax credit corresponding to the tax obligations due for dividends obtained from subsidiary companies located abroad. In these cases, the tax credit corresponding to the tax paid for the net income is provided (until the payment of the dividends).

A country could apply a tax on its residents' income and its economic entities based on their legal relationship or on any income source from that specific country. The fiscal practice worldwide recognizes the existence of three criteria that taxation could be based on as follows: residency – tax domicile, nationality – citizenship and territoriality.

The criterion of residence or tax domicile involves the taxation of all income and wealth belonging to a taxpayer by the tax authority in the country where he is registered as a resident, as a natural or legal person with the fiscal domicile in that country, which gives the tax payer the quality of subject to taxes. The application of this principle does not take into account whether the income or wealth that is the subject of taxation is obtained or whether it is within the territory of that state or outside its borders.

Different criteria are used to determine the residence of legal entities in different states. The residence is established according to the place of registration of the company's statute in France, according to the headquarters of management, or according to both criteria in Italy. In Germany, the doctrine of "control" predominates, according to which for tax purposes it is considered by whom and where the company is managed. Consequently, according to the fiscal practices applied in Germany, all income obtained from the international activity of foreign resident company is taxed in Germany. This criterion is applied, especially by economically developed countries, as it is frequent that the natural and legal persons from these countries realize incomes and hold assets on the territory of other states. In Romania, the natural person is considered a resident in the state in which he has a permanent residence and in the case of a legal person, it is considered a resident of the state in which the effective management is located.

According to the criterion of citizenship or nationality of the taxpayer, the tax burdens is on the citizens of a state that make income or possesses wealth from or in the respective state, regardless if they live in the country in which they are citizens or not.

The territoriality or the criterion of origin of the incomes stipulates that the tax is calculated and collected by the fiscal body from the country where the incomes are made or the goods are located, regardless of the residence or the nationality of the income beneficiary or of the property owners. According to this criterion, salaries, the profit of enterprises, incomes from free professions, interests, dividends and rents are taxed.

The elaboration and publication of the OECD Model Convention for the elimination of double taxation was the crowning of international efforts over a period of over 70 years to address the problems caused by double taxation. In other words, the Model Convention seeks, where it is possible to specify, for each situation, a single rule. However, in certain cases it has been necessary to allow some flexibility in the regulations of the Convention, compatible with its efficient implementation. Member States enjoy a certain freedom in determining the tax rate, by withholding tax, on dividends and interest, choosing the method for eliminating the double taxation and fulfilling certain conditions when distributing the profits of a permanent establishment. The best proof of viability of the solutions provided in the convention is the large number of treaties that followed the structure and guidelines offered by this convention.

The sole purpose of concluding these conventions is to share the right of taxation between the state of residence and of origin. In certain proportions, Romania, through domestic legislation, applies unilateral legislative measures to avoid international double taxation both through the institution of tax credit and through the norm of reference to fiscal conventions mentioned in the Fiscal Code applicable tax. In other words, the double taxation treaties represent the limits permitted by the fiscal system of a country, but they are not the fiscal system itself.

At present, more than 85 international conventions on the avoidance of double taxation are being implemented in Romania, which in one way or another are aimed at creating a preferential and stable tax regime for domestic and foreign economic agents. The settlement of a large number of tax agreements between countries around the world has led to the need to develop international standards for the taxation conventions of avoiding double taxation, such as the OECD Model Tax Convention and Model Double Taxation Convention of the United Nations.

The residency notion is important for the decision regarding which tax rate should apply, as well as the existence of a permanent establishment in order to determine the territoriality. Both concepts lay at the basis of each double tax treaty, which leads to the use of international methods in order to eliminate double taxation. These methods are the following:

- Tax exemption – exclusion of incomes from foreign source from the taxable base;
- Fiscal credit – the transfer of the tax paid abroad;
- Tax deduction – the transfer of the fiscal obligations paid abroad by lowering the tax liability.

Below, we have presented the tax rates according to the double tax treaties in place regarding the countries under observation (all the rates are sourced at https://taxsummaries.pwc.com/):

- **Eastern countries**

Table 3. Romanian tax rates according to the double tax treaties

- % -

Residency state	Rates applied by Romania				
	CIT	PIT	WHT		
			Dividends	Interest	Royalties
Bulgaria	16	10	4 or 10	7	5
Poland	16	10	5 or 15	10	10
Germany	16	10	5 or 15	0 or 3	3
France	16	10	10	10	10
Italy	16	10	0 or 5	0 or 5	5

Table 4. Bulgarian tax rates according to the double tax treaties

- % -

Residency state	Rates applied by Bulgaria				
	CIT	PIT	WHT		
			Dividends	Interest	Royalties
Romania	10	10	5	0 or 5	5
Poland	10	10	10	0 or 10	5
Germany	10	10	5 or 15	0 or 5	5
France	10	10	5 or 15	0	5
Italy	10	10	10	0	5

Table 5. Polish tax rates according to the double tax treaties

- % -

Residency state	Rates applied by Poland				
	CIT	PIT	WHT		
			Dividends	Interest	Royalties
Romania	19	17 or 32	5 or 15	0 or 10	10
Bulgaria	19	17 or 32	10	0 or 10	5
Germany	19	17 or 32	5 or 15	0 or 5	5
France	19	17 or 32	5 or 15	0	0 or 10
Italy	19	17 or 32	10	0 or 10	10

- **Western countries**

Table 6. German tax rates according to the double tax treaties

- % -

Residency state	Rates applied by Germany				
	CIT	PIT	WHT		
			Dividends	Interest	Royalties
Romania	30 to 34	14 to 42	5 or 15	0 or 3	3
Bulgaria	30 to 34	14 to 42	5 or 15	5	5
Poland	30 to 34	14 to 42	5 or 15	0 or 5	5
France	30 to 34	14 to 42	5 or 15	0	0
Italy	30 to 34	14 to 42	15	0 or 10	0 or 5

Table 7. Italian tax rates according to the double tax treaties

- % -

Residency state	Rates applied by Italy				
	CIT	PIT	WHT		
			Dividends	Interest	Royalties
Romania	24 to 28	23 to 43	0 or 5	0 or 5	5
Bulgaria	24 to 28	23 to 43	10	0	5

Residency state	Rates applied by Italy				
	CIT	PIT	WHT		
			Dividends	Interest	Royalties
Poland	24 to 28	23 to 43	10	0 or 10	10
Germany	24 to 28	23 to 43	10 or 15	0 or 10	0 or 5
France	24 to 28	23 to 43	5 or 15	0 or 10	0 or 5

Table 8. French tax rates according to the double tax treaties

- % -

Residency state	Rates applied by France				
	CIT	PIT	WHT		
			Dividends	Interest	Royalties
Romania	28	0 to 45	10	0	10
Bulgaria	28	0 to 45	15	0 or 5	10 or 15
Poland	28	0 to 45	15	5	10
Germany	28	0 to 45	15	0	10
Italy	28	0 to 45	15	0 or 5 or 15	10

These agreements are an accepted and useful tool for organizing international cooperation. While they address many issues that could arise from a bilateral agreement, double taxation treaties do not give any government the right to violate the basic rights offered by the EU Treaty to all its citizens or companies as long as they are aligned with the OECD Model Convention. Therefore, agreements between EU Member States must be developed and must operate in accordance with the EU Treaty.

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